In Deregulation, Plants Turn Into Blue Chips

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Four big investment firms bought a group of Texas power plants in 2004 for $900 million and sold them the next year for $5.8 billion.

Sempra Energy, parent of the utility in San Diego, bought nine Texas power plants with two partners in 2004 for $430 million, selling two of them less than two years later for more than $1.6 billion.

Goldman Sachs and its partners bought power plants in upstate New York, Pennsylvania and Ohio starting in 1998 and sold them in 2001 at a profit of more than $1 billion.

These extraordinary profits have come during a decade-long effort in about half the states to overhaul the business of producing electricity — in the name of stimulating competition and lowering utility bills.

But even as some investors have profited handsomely by buying and sometimes quickly reselling power plants, electricity customers, who were supposed to be the biggest beneficiaries of the new system, have not fared so well. Not only have their electricity rates not fallen, in many cases they are rising even faster than the prices of the fuels used to make the electricity. Those increases stand in contrast to the significantly lower prices in other businesses in which competition was introduced, such as airlines and long-distance calling.

Some electricity customers are also being saddled with monthly surcharges to cover construction costs for plants that were sold at bargain prices and then resold at huge profits. Some of these surcharges will continue for years.

Analysts cite several reasons that the new system has not been as successful as hoped.

Regulators required some utilities to sell their power plants so that independent electricity producers could compete on equal footing with those plants. But not enough new competitors emerged.

And sometimes regulators allowed utility holding companies to transfer plants from their regulated utilities to unregulated wholly owned subsidiaries. When some of these unregulated sister companies still found it hard to turn a profit, regulators allowed the plants to become regulated companies again, so they were virtually guaranteed state-approved profit rates.

By last year, only 63 percent of the nation’s electricity generating capacity was owned by utilities, down from almost 90 percent 10 years ago. Often customers did not come out ahead, critics of the new system say.

Take the case of the Texas power plants. After the Texas Legislature, urged by Enron and big industrial customers, voted to make electricity generation a competitive business, the utility serving the Houston area sold 60 power plants that generate most of the power for the area to four investment firms — the Texas Pacific Group, the Blackstone Group, Kohlberg Kravis Roberts and Hellman & Friedman — which soon resold the plants at the $5 billion profit.

But state regulators have ordered electricity customers to pay an average of $4.75 monthly for 14 years to finish paying for the construction of the power plants, plus interest.

And the utility that sold the plants, Centerpoint, is suing for even higher payments from customers. Houston-area consumers now pay among the highest electricity rates, nearly double the national average.

Supporters of deregulation said customers would benefit from healthy competition among a growing number of electricity producers. But such competition has not developed. For one thing, many of the new power plants failed because, unlike many of the old plants, they almost all used natural gas to produce electricity. Demand for natural gas soared, and the price for that fuel tripled, making electricity from these plants too costly to be competitive.

The value of these plants collapsed, and some owners sought refuge in bankruptcy court. That is when investment firms, anticipating a much higher price for the plants’ electricity, bought them for as little as 20 cents for each dollar spent to build them.

And in fact the investment firms calculated doubly right: By paying so little for the plants, they made the construction costs of new plants by competitors seem prohibitively expensive. Over the last five years, few new power plants have been built, although demand for electricity has risen.

The story has been different for electricity customers. Many of the power plants that were sold are still owned by the utilities’ parent companies; they were simply transferred from the regulated utilities to unregulated sister companies. Some regulators allowed utilities to favor the sister companies with long-term contracts even if they did not offer the best price for electricity.

In fact, independent electricity producers argue that their modern generating plants often sit idle while older, inefficient plants owned by politically powerful utilities and their unregulated sister companies whir around the clock under long-term contracts. For example, Calpine, an independent generating company, and some big industrial customers have complained that Entergy, the Louisiana utility holding company, is favoring its own plants when Calpine's power would be cheaper. Congress has ordered studies of the issue.

Because utilities are still allowed to pass on the cost of the power they buy, they have little incentive to choose a cheaper supplier. Electricity customers therefore end up paying more than they would have to if electricity production were truly competitive.

After Baltimore Gas & Electric transferred its 12 power plants to an unregulated affiliate and became only a distribution company, it continued to buy 70 percent of its electricity from the plants because there were not enough independent generators to supply the area's needs. Baltimore Gas & Electric sought a 72 percent rate increase this year, causing such an outcry that Maryland regulators gave it only an immediate 15 percent, but with big additional increases virtually guaranteed over the next few years.

Paul Allen, a spokesman for the utility's parent company, Constellation Energy, said that Baltimore Gas & Electric rates had been frozen since 1993 and that the increase largely reflected the higher price of producing electricity, including the cost of fuel. He said a rate increase was inevitable regardless of the new system.

But Robert McCullough, a utility economist and consultant, disagreed and blamed the new system. He said that in places like Baltimore, where a utility's plants were sold to an unregulated sister company, "the same energy is generated by the same plants, owned by the same owners, and sold to the same customers, simply at a vastly higher price."

Ralph Nader, head of the watchdog group Public Citizen, said that many power plants were sold for artificially low prices and that state regulators often failed to protect customers. He said regulators should have required price protection to shield consumers from a "double header corporate gouge, where the defenseless customer is paying twice for the same power plants."

The American Electric Power Company, which owns utilities in 11 states, sold nine of its Texas power plants to SEMPRA, the parent of a San Diego utility company, and the Carlyle Group in 2004 for $430 million. SEMPRA and Carlyle quickly resold two of the plants for $1.6 billion. American Electric wanted customers to pay an average of $9 a month for 14 years to cover the difference between the cost of building the plants and the lower price for which it sold them, plus interest. But because the resold plants went for 15 times as much per unit of generating capacity, state regulators questioned whether the utility should have sold the plants for higher prices. Still, regulators have required customers to pay on average $5 per month for 14 years, or more than $800 each.

There are persistent allegations that many plants have become inordinately profitable for their new owners; in some cases, disputes have arisen over just how profitable the plants are. In Connecticut, three plants together earn at least $700 million in annual profits, money that is over and above the 10 percent profit they would earn if they were still in the regulated system, Attorney General Richard Blumenthal said. He wants the state to end the new system and return to a more regulated system or even have a state agency provide power.

The plant owners, P.S.E.& G. and Dominion, said that the profit estimates were “wildly exaggerated” and that most of the power was sold at fixed prices with profits not significantly different from what regulated plants would earn. They did not release precise profit figures.

In Ohio, the state’s consumer advocate, Janine Migden-Ostrander, said the potential savings from a competitive electricity industry were undercut by favoritism that regulators showed to utility companies.

In effect, she said, Ohio regulators allowed an extremely favorable price when unregulated sister companies acquired power plants. The lower the price a sister company pays for a power plant, the more difficult it is for an independent power producer that must build an expensive new plant to compete. That “is how the utilities killed the market before it could be started,” she said.

Lynn Hargis, a longtime utility regulation lawyer who now volunteers as counsel to Public Citizen, said the terms under which power plants were sold are “the equivalent of selling your grandmother’s house for the price she paid 60 years ago, less depreciation. No one would do that.”

The utilities say that no one knew at the time the plants were sold that they would later soar in value. Floyd Le Blanc, a spokesman for Centerpoint, the Texas company that sold the 60 Houston-area plants, said, “We complied with all legal and regulatory requirements.” His remarks were echoed by other utilities.

But even after buying plants at low prices, some utilities have been unable to profit in a competitive setting after decades of operating in a regulated market, where profits are virtually guaranteed. State governments have provided a refuge.

Corporate parents with both regulated utilities and unregulated power plant companies have persuaded sometimes reluctant regulators to allow them to put failing plants into the hands of the regulated utilities, where they were almost certain to turn a profit, said Richard Stavros,

executive editor of Public Utilities Fortnightly, a trade magazine. That has happened in Arizona, Missouri, Texas and other states.
Arizona Public Service, for example, brought five plants owned by its unregulated affiliate, Pinnacle Energy West, into the utility. The staff of the state board that regulates utilities at first opposed the deal, saying it was not in the best economic interests of customers. But the staff relented after Arizona Public Service promised it would not add any power plants to its regulated operations before 2015, which may encourage others to enter the market.
The Federal Energy Regulatory Commission recently approved a deal to move a Texas power plant back into a regulated utility, although it expressed concern that allowing utilities' parent companies to salvage their failed investments in the competitive market could be unfair to competing generating companies.
The sale back to utilities of power plants that are not making money is "a disturbing national trend," said Jan Smutny-Jones, executive director of Independent Energy Producers in Sacramento, Calif., a trade association for power plant owners.
"It's a great deal," he said, "having ratepayers cover your managerial mistakes."